Investment Insights | April 2024

Enhanced Middle Market Credit: Investment Case Studies

The Voya Enhanced Middle Market Credit Strategy's allocation to higher-collateral industries is more than double the sector average. The Strategy also offers diversification of opportunity set, investing in project finance and private placement deals that many other funds can't access. Here are some examples.

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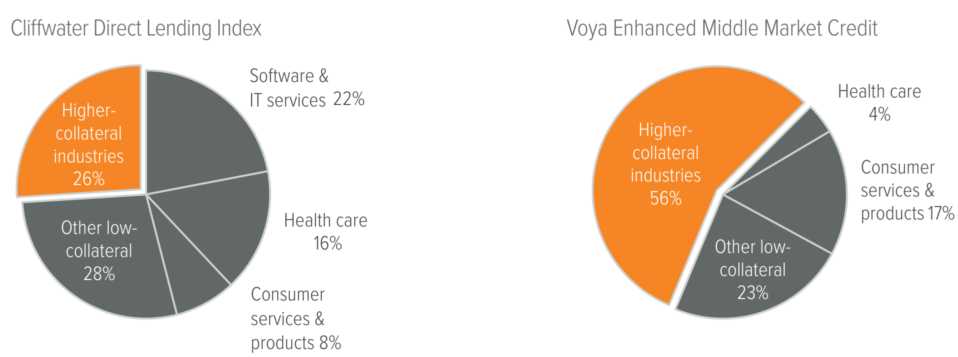
Key transaction highlights

- **Middle market deal:** A leading helicopter transportation provider to the oil & gas and air medical industries, with a clean balance sheet and low leverage, repaid around 300 basis points above the estimated yield to maturity at the time of underwriting.
- **Project finance deal:** A cobalt mining company, which was well positioned to benefit from growth in electric vehicle production, had its deal economics improved by our team, leading to a well-structured transaction that resulted in an IRR around 90 bp above the estimated yield to maturity at the time of underwriting.
- **Private placement deal:** A power supplier with long-term power purchase agreements with multiple investment grade counterparties had our team lead negotiations on deal structure and documentation, which achieved structural improvements that resulted in the company prepaying at 104 cents on the dollar.

Investing through a credit-centric lens

Over the decade that the Voya Enhanced Middle Market Credit (EMMC) Strategy has been running, it has invested 56% of its assets in higher-collateral industries, versus a middle market fund average of 26% (based on the $295 billion Cliffwater Direct Lending Index). Its top investment sectors are industrials, manufacturing, chemicals, and aerospace & defense. And, unlike many of its peers, the Strategy has invested 0% in software and tech (Exhibit 1).

Exhibit 1: Loan collateralization: Voya's EMMC strategy vs. the market



As of 03/12/2024. Source: CDLI, Voya IM.

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Given current market technicals—specifically, the prevalence of low-collateral loans in many large middle market funds—bringing a higher-collateral strategy such as EMMC into the mix can both add alpha and provide risk mitigation, with little to no overlap with existing allocations.

In fact, 44% of EMMC's historical capital deployment has been in loan types where the mega-funds simply don't—and in many cases can't—participate: project finance and private placement.

To help familiarize investors with the EMMC process, we present past transactions highlighting various deal types, as well as the value the team adds and the level of collateral we prefer.

Middle market: Helicopter transport services

Company: One of the largest providers of helicopter transportation services on the Gulf of Mexico. The team believed the company was well positioned to maintain its market share and had upside exposure to a recovery in energy prices and production growth in the Gulf of Mexico.

Origination: This opportunity came through Voya EMMC's relationship with the lead arranger, which sought to raise $225 million through a senior secured term loan facility to support the company's exit from Chapter 11. The company had been forced into a Chapter 11 filing as a result of deteriorating market conditions and an over-levered balance sheet. The lead arranger typically brought broadly syndicated deals to the market, and it had an extensive relationship with Voya's CLO team. However, due to the illiquidity of this term loan facility, the arranger connected with the EMMC team: Given our experience with workouts and restructurings, we were well positioned to evaluate the opportunity.

Investment thesis:

- Balance sheet strength: The investment's primary appeal was the company's clean balance sheet and low leverage as it exited the Chapter 11 process, combined with discrete businesses that allowed for diversification of revenue streams and pockets of value.
- Good collateral: There was solid valuation coverage using a variety of different approaches, including: (i) a sum-of-the-parts valuation approach of the company's main segments: domestic and international oil & gas, and air medical and tech services; (ii) the debtor's valuation, which supported its plan of reorganization; (iii) the trading level of pre-petition unsecured notes to be equitized; and (iv) the collateral valuation of the company's owned fleet.
- Strong industry position: From an underwriting point of view, the company's emergence from Chapter 11 created an unusual competitive advantage relative to its peers, who were also in distress and not as far along in their restructuring efforts. Post-deal, the company had significantly lower leverage than its competition, which provided further flexibility. Its total debt was reduced by $475 million, with pro forma net leverage of 2.4x and $75 million of cash on its balance sheet.

Exhibit 2 shows key structural changes that Voya's EMMC team achieved, improving the initial offering. After these changes, Debtwire assigned a covenant score of 9 out of 10, well above the market average of 5.8.

Investment outcome: The deal fully repaid around 300 basis points above our estimated yield to maturity at underwriting, validating the investment thesis.

Exhibit 2: Helicopter transport services: Terms at offer vs. Voya's final deal

Structure	Proposed	Final
Price	L + 650-700	L + 700
Minimum liquidity covenant	$15mn	$20mn
ABL carveout	$75mn	$50mn
Limitation on foreign subsidiaries	None	Indebtedness limited to $15mn and a key foreign business included in the restricted group
Incremental facility	Unlimited pari-incremental facility up to 2.5x	Removed completely
Reinvestment rights from air medical sale	50% sweep subject to customary reinvestment rights	100% sweep with no reinvestment rights

Project finance: Cobalt mining

Company: The company owned two primary assets: (i) an existing inventory of conflict-free cobalt and (ii) a cobalt metal stream that required the counterparty (one of the largest investment-grade-rated mining companies) to deliver 32.6% of finished cobalt production from its nickel operations in Canada. The Voya EMMC team believed the company was well positioned to benefit from the growth in production of electric vehicles and battery energy storage, as cobalt is a key component of existing battery chemistries.

Origination: The lead arranger on a bank syndication effort reached out to Voya EMMC to get our take on a proposed structure (due to our experience evaluating esoteric structured credits). We told them the structure would likely face major hurdles, as it allowed equity to be repaid while debt remained at full risk with a large bullet maturity. We outlined a counterproposal for consideration in the event they were unable to fill the deal as offered. When the syndication fell through, Voya EMMC was able to step in as the sole institutional lender to lead the term loan tranche. In the process, we were able to maximize allocation, drive significant structural changes and improve deal economics (Exhibit 3).

Investment thesis:

- Good market fundamentals: Our analysis showed a favorable outlook for the cobalt market, driven by growing EV demand globally. Cobalt demand was expected to grow by 60% from 2019 through 2025, as roughly 50% of demand is tied to battery chemical production.
- Differentiated product: At the time of underwriting, around 75% of mined cobalt came from the Democratic Republic of the Congo, a politically unstable country with a prevalence of unregulated artisanal mining. In contrast, the company's stream of cobalt production was based in the highly regulated jurisdiction of Canada, which meant the product should sell at a premium and have lower elasticity of demand.
- Experienced operations partner: All operational and capex risk related to the cobalt mining under the streaming agreement stayed with the experienced mining operator, which was the largest nickel producer and the fourth-largest mining company at the time of underwriting, with a market cap of around $57 billion. The mining operator had a credit rating of BBB-/Ba1, indicating a low counterparty risk, and was subject to onerous penalties if it did not meet certain volume thresholds.
- Deep industry knowledge: Based on our conversations with key stakeholders, including auto manufacturers, we recognized the sponsor's exclusive focus on the mining and raw materials sector as a credit strength, given its extensive knowledge of market supply/demand dynamics and potential developments.

Investment outcome: Deal fully paid off, as the sponsor sold the stream at a valuation of around $320 million (including earnout), compared with our underwriting valuation of $235 million. We realized an IRR of around 90 bp above our underwriting yield, which validated the investment thesis.

Exhibit 3: Cobalt mining: Terms at offer vs. Voya's final deal

Structure	Proposed	Final
Original issue discount (OID)	99.25	98
Excess cash flow sweep	Existing inventory: 0% Stream sales: 30% until bullet tranche is fully repaid; 15% thereafter	Existing inventory: 100% through 2021 Stream sales: 70% until bullet tranche is fully repaid; 25% thereafter
Equity distribution restriction	Very limited; 100% of excess proceeds from sale of existing inventory; 70% until the bullet is repaid	No distribution of excess proceeds from sale of existing inventory; 30% until bullet tranche is fully repaid

Private placement: Power generation

Company: A leading provider of distributed power generation services using fuel cell technology, which provided highly reliable power supply solutions through long-term contracts (averaging 13 years) under six power purchase agreements (PPAs) with multiple investment grade counterparties.

Origination: The EMMC team sourced the opportunity through the private placement desk of a bulge bracket firm. Voya was invited to the process due to our investment grade private credit team's participation in a private placement at the power purchase agreement level. As the first committed investor, we led the negotiations on deal structure and documentation, and we achieved structural improvements that brought in two other investors to successfully complete the deal (Exhibit 4).

Investment thesis:

- Diversified revenue stream: The company generated revenue from around 360 separate, already-operational sites that worked independently from each other, serving 14 different customers.
- Highly predictable collateral: A lockbox mechanism was in place for cash capture of existing take-or-pay PPAs with loan-to-value (LTV) of around 30% and a tenor 5.7 years longer than note maturity.
- Excellent performance history: An availability factor of 99.7% and strong momentum at the time of underwriting, with buy-in from utility-scale operators.
- Strong debt service coverage ratios: Minimum and average DSCR of 1.19x and 1.80x, respectively, including heavy principal amortization. We also included a tight 25% cushion for the DSCR covenant.
- Compelling customer proposition: The company was able to provide electricity at prices lower than grid in high-power-price regions, with much higher reliability and significantly lower CO_2 emissions.
- High barriers to entry: A 10-year R&D head start, along with multibillion-dollar investments in the technology from institutional investors over the past 10 years.

Investment outcome: The company wanted to expand its financing sources but was limited by our structural covenants. This prompted it to pay off the notes at the prepay price of 104 cents on the dollar, validating the effectiveness of our structure.

Exhibit 4: Power generation: Terms at offer vs. Voya's final deal

Structure	Proposed	Final
Pledged cash flows to lockbox	$816mn	$1,173mn
Loan-to-value	32%	15%
Coupon	9%	10%
Prepay protection	NC2, 102, 101	NC2.5, 104, 102, 101
Term (yrs)	8	7
Rating	Unrated	Requirement to produce private letter rating at issuer's expense

Enhanced Middle Market Credit: Diversification, downside mitigation, deal flow

The EMMC team has over 20 years of experience in the workout and middle market space, and it has been running the Strategy successfully for the past decade. For the first time, participation in EMMC has been opened up beyond the Voya general account and SMAs into a fund structure—with a strong handful of deals already placed.

We look forward to talking with you about how an allocation to EMMC could potentially add diversification and alpha to your middle market portfolios.

Deals shown are illustrative examples only.

Risks of investing

Middle market, private placement and project finance loans: The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

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